No. 89-1484

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

INVESTMENT COMPANY INSTITUTE,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

ON CONDITIONAL PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR AMERICAN STOCK EXCHANGE, INC., CHICAGO BOARD OPTIONS EXCHANGE, INCORPORATED, AND THE OPTIONS CLEARING CORPORATION IN OPPOSITION

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INTRODUCTION

This matter arises out of consolidated proceedings before the Court of Appeals for the Seventh Circuit on petitions filed pursuant to Section 25(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. §78y(a) (1988), by the Chicago Mercantile Exchange ("CME"), Board of Trade of the City of Chicago ("CBT"), and the Investment Company Institute ("ICI") for review of two orders entered by the Securities and Exchange Commission ("SEC") approving certain rules changes of the American Stock Exchange, Inc. ("AMEX"), the Chicago Board Options Exchange, Incorporated ("CBOE"), The Options Clearing Corporation ("OCC"), and the Philadelphia Stock Exchange, Inc. ("PHLX"). The Court of Appeals reversed the SEC orders in the proceedings instituted by the CME and CBT (Nos. 89-1763 and 89-1786) and dismissed the proceedings instituted by the ICI (No. 89-2012) as moot.

AMEX, CBOE and OCC[1] were intervening respondents in those consolidated proceedings. On March 22, 1990, AMEX, CBOE and OCC filed a joint petition for a writ of certiorari with respect to the judgment of the Court of Appeals in Nos. 89-1763 and 89-1786, and that petition is pending as No. 89-1502 before the Court.[2] On March 22, 1990, PHLX also filed a petition for a writ of certiorari with respect to the judgment in Nos. 89-1763 and 89-1786, and that petition is pending as No. 89-1503 before the Court.

STATUTES INVOLVED

ICI's conditional petition for a writ of certiorari (the "ICI Petition") involves the Investment Company Act of 1940 (the "Act"), 15 U.S.C. §§80a-1 to 80a-64 (1988). Particularly involved are Sections 3(a) and 3(b)(1) of the Act, 15 U.S.C. §§80a-3(a) and 80a-3(b)(1) (1988). The text of these two sections is set forth in the Appendix to this brief.

STATEMENT OF THE CASE

On April 11, 1989, the SEC entered orders pursuant to the provisions of the Exchange Act approving rules proposals of AMEX, CBOE, PHLX and OCC which provided for the issuance and trading of, and the clearance and settlement of transactions in, a new form of financial instrument called an "index participation" ("IP"). IPs and the proceedings before

[1] Pursuant to Rule 29.1 of the Rules of this Court, AMEX, CBOE and OCC state that they have no parent companies or subsidiaries (other than wholly owned subsidiaries), except that (i) National Securities Clearing Corp., Securities Industry Automation Corp., and The Depository Trust Company are non-wholly-owned subsidiaries of AMEX, and (ii) The Cincinnati Stock Exchange is a non-wholly-owned subsidiary of CBOE. The stocks of AMEX, CBOE and OCC are not publicly traded. Control of AMEX, CBOE and OCC is vested in their respective members.

[2] This petition is hereinafter referred to as the "AMEX Petition" and cited as "AMEX Pet. ."

the SEC are more fully described in the Statement of the Case contained in the AMEX Petition. (AMEX Pet. 2-7).

In the proceedings before the SEC, ICI and its counsel filed comments arguing that IPs involved the unlawful creation and operation of unregistered investment companies in violation of the Act. In its order approving the rules of AMEX, CBOE and PHLX, the SEC found that there is no "investment company" within the meaning of Section 3(a) of the Act, 15 U.S.C. §80a-3(a) (1988), because there is no issuer "that is either 'engaged . . . primarily in the business of investing, reinvesting, or trading in securities' or 'engaged . . . in the business of investing, reinvesting, owning, holding, or trading in securities, and owns . . . investment securities having a value exceeding 40 per centum of the value of such issuer's total assets. . . .' " (A. 36f).[3] The SEC further found that OCC, which is the issuer of IPs, is "primarily engaged 'in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities' " (A. 36f-37f), which means that OCC is not an investment company within the meaning of the Act. Section 3(b)(1) of the Act, 15 U.S.C. §80a-3(b)(1) (1988). The SEC further found that, in view of the regulation of the three exchanges and OCC under Sections 6 and 17A of the Exchange Act, "no purpose . . . would be served by subjecting this arrangement to investment company regulation." (A.37f). Finally, the SEC found that an investment company does not exist "within the OCC (or OCC combined with the exchanges), the IP purchasers viewed collectively, or the IP shorts viewed collectively." Thus, the SEC distinguished the case of *Prudential Insurance Co. v. Securities and Exchange Commission*, 326 F.2d 383 (3d Cir.), *cert. denied*, 377 U.S. 953 (1964), by expressly finding that "no separate investment company" exists in the case of IPs. (A. 37f).

[3] Citations to "A. " are to the Appendix accompanying the ICI Petition.

The Statement of the Case contained in the ICI Petition is erroneous in a number of respects. First, the statement (at page 4) that the SEC "specifically recognized that the IP programs involve, in economic substance, the creation and operation of investment companies" is plainly erroneous. As the foregoing description of the SEC order makes clear, the SEC expressly found that IPs did *not* involve the creation of an investment company within the meaning of the Act, and there is no place in its order where the SEC found (or "specifically recognized") that IPs involved the creation of an investment company. The SEC order did state that an "IP is a present interest in the current value of a portfolio of stocks" (A. 2f), but the order did not "recognize" nor "admit," as suggested by ICI (ICI Pet. 4), that IPs therefore involved the creation of an investment company.[4] Unfortunately, ICI compounds this error by twice later wrongfully saying that "the SEC admitted that the IP programs involve, in economic substance, the creation and operation of investment companies." (ICI Pet. 14; *also see* ICI Pet. 10).

Second, the ICI Petition is erroneous in asserting that "the SEC stated that the . . . Act has no application because the IP programs supposedly involve no 'issuer' within the meaning of the Act" (ICI Pet. 10), and that the SEC "declared the Act inapplicable on the grounds that IP programs involve no 'issuer' within the meaning of the Act." (ICI Pet. 14). As noted above, the SEC did not decide that IPs were not within the Act because there was no "issuer" within the meaning of the Act. The SEC order does not even discuss

[4] SEC Commissioner Cox commented at an open hearing that "taking all of the characteristics on balance, that these index participation products seem most like a type of mutual fund, an index fund" (A. 3h), but he did not "admit" that IPs involved the creation of an investment company. To the contrary, he specifically concurred in the SEC's order, which found that IPs do not involve the creation of an investment company. (A. 51f-52f). In any event, Commissioner Cox's comments do not constitute the findings or admissions of the SEC.

this. Rather, it is clear on the face of the SEC order that the SEC found that the IP program does not involve the creation of an investment company within the meaning of Section 3(a) of the Act and that, in any event, OCC is not an investment company by virtue of the provisions of Section 3(b)(1) of the Act. (A. 36f-37f).

Third, the ICI Statement of the Case is erroneous in stating that an IP entitles the holder "to receive payments representing the capital appreciation" on the stocks comprising the underlying index and that holders are "entitled to receive from the OCC" capital gains and losses on the index stocks. (ICI Pet. 8). These statements are not correct. OCC has no obligation to pay, and the holder of an IP is not entitled to receive, capital appreciation on the index stocks.[5] A holder of an IP can receive gain or loss in only two ways. He can sell the IP in the market, in which case his gain or loss will be the difference between the proceeds he receives on the sale and the price he paid when he bought the IP. He can also exercise the cash-out privilege of the IP,[6] in which case his gain or loss will be the difference between the cash he receives and the purchase price he originally paid.

Fourth, the ICI Petition is in error in its references to IP "longs" and IP "shorts" as separate securities. (ICI Pet. 8–9). An IP is a single security which is bought or sold on an exchange in a single transaction—the buyer becomes the

[5] One of the ways in which IPs are different from futures contracts is that payments are made every day by the parties to a futures contract to reflect changes in the market value of the contract. *See* S. Rep. No. 1131, 93rd Cong., 2d Sess. 17, *reprinted in* 1974 U.S. Code Cong. & Admin. News 5843, 5857-58. Such payments are not made to reflect the changes in value of IPs or of the underlying index stocks.

[6] ICI refers to the exercise of the cash-out privilege as "redeeming" the IP. (ICI Pet. 8). However, an IP is clearly not a "redeemable security" within the meaning of Section 2(a)(32) of the Act, 15 U.S.C. §80a-2(a)(32) (1988).

holder of the security and is colloquially known as the "long," and the seller is known as the writer or the "short." The transaction is then cleared through OCC—that is, cash payment of the purchase price of the security is made by the buyer to the seller through the facilities of OCC. The buyer then becomes entitled to the two basic rights of an IP holder —the right to receive dividend equivalents and the privilege to exercise the IP—and the seller becomes obligated to OCC to perform the corresponding obligations. It is a plain misdescription of this clearing process to say, as ICI does (ICI Pet. 8), that "OCC uses the proceeds received from the continuous sale of IP 'longs' to invest in securities in the form of IP 'shorts.' "

ARGUMENT

AMEX, CBOE and OCC agree with ICI that "[t]his case presents fundamental questions of national importance" relating "to the allocation of regulatory jurisdiction over IPs and similar products between the CFTC and the SEC." (ICI Pet. 13). On the other hand, we believe that the question presented by the ICI Petition—whether IP programs involve the creation of an investment company within the meaning of the Act[7]—is not such a question. Whether a person is an investment company within the meaning of Section 3 of the Act is, contrary to the ICI's assertion (ICI Pet. 14), essentially a fact-based question which need not be reviewed by this Court as a matter of first impression.[8]

[7] ICI's overblown description of the issue in its argument, saying that it presents the question "of the SEC's power effectively to repeal, through administrative fiat, the comprehensive statutory scheme" of the Act (ICI Pet. 13), does not match the narrowness of the question actually presented by ICI. (ICI Pet. i).

[8] Section 25(a)(4) of the Exchange Act, 15 U.S.C. § 78y(a)(4) (1988), provides that the SEC's finding "as to the facts, if supported by substantial evidence, are conclusive." ICI does not suggest that the facts found by the SEC are not supported by substantial evidence.

Moreover, this is a very different type of question—both in terms of importance and ripeness—from the questions raised by the pending AMEX and PHLX Petitions. The Act defines what is, and what is not, an "investment company" with great specificity, and a decision one way or another on a particular fact issue will not have significant national implications.[9] On the other hand, the term "futures contract" is not defined in any federal statute and has not been defined by this Court, yet its meaning has important implications in respect of the regulation, structure and competitiveness of a wide array of financial instruments.

AMEX, CBOE and OCC are sympathetic to the interest of efficiently disposing of the question presented by the ICI Petition at the same time as the issues raised by the AMEX and PHLX Petitions. However, in this case, that interest is outweighed by other considerations. First, the issues raised by the AMEX and PHLX Petitions are complex and fundamentally important, and it would unduly and unnecessarily complicate the resolution of those issues to add the question presented by the ICI Petition. Second, the question presented by ICI has not been considered by the Court of Appeals and is not yet ripe for review. In the event the Court should reverse the judgment of the Court of Appeals, it would be appropriate to remand with instructions to consider the merits of ICI's petition for review.

[9] Section 6(c) of the Act, 15 U.S.C. § 80a-6(c) (1988), gives the SEC authority to exempt any person, security or transaction from the provisions of the Act "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act. Since the SEC has stated that it "sees no purpose that would be served by subjecting this arrangement to investment company regulation" (A.37f), it would seem that the decision as to whether IPs involve the creation of an investment company would not have significant practical consequences.

CONCLUSION

ICI's conditional petition for a writ of certiorari should be denied.

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APPENDIX

STATUTES INVOLVED

Investment Company Act of 1940 (the "Act"), 15 U.S.C. §§80a-1 to 80a-64 (1988)

Section 3(a) of the Act, 15 U.S.C. §80a-3(a) (1988)

§80a-3. Definition of investment company

Definitions

(a) When used in this subchapter, "investment company" means any issuer which—

(1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

(2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

As used in this section, "investment securities" includes all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which are not investment companies.

* * *

Section 3(b)(1) of the Act, 15 U.S.C. §80a-3(b)(1) (1988)

§80a-3. Definition of investment company

Exemption from provisions

(b) Notwithstanding paragraph (3) of subsection (a) of this section, none of the following persons is an investment company within the meaning of this subchapter:

(1) Any issuer primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities.